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ALTERNATIVE GUIDING PRINCIPLES FOR THE USE OF MONETARY POLICY

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The author, Harry G. Johnson, was formerly Professor of Economic Theory at the University of Manchester and is now Professor of Economics at the University of Chicago and Editor of the JOURNAL OF POLITICAL ECONOMY. *He has written several important books, perhaps the best-known being* INTERNATIONAL TRADE AND ECONOMIC GROWTH *and* MONEY, TRADE, AND ECONOMIC GROWTH.

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FRITZ MACHLUP, *Director*
International Finance Section

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Introduction

This paper is directed to the specific question: what should monetary policy seek to do in the Canadian economy?

Monetary policy as traditionally conceived is concerned with short-run economic stabilization, the damping of the business cycle. This function has come to be expressed customarily in terms of the pursuit of the two objectives of price stability and high employment. Insofar as prices and general economic activity tend to move upwards or downwards together, these two objectives do not conflict, but are essentially the same: a monetary policy directed at stabilizing either one of the price level or the level of unemployment would tend to stabilize both. The two objectives may, however, conflict if the level of unemployment considered desirable itself implies a rising trend of prices, or if the price level is rising for some reason other than an excessively low level of unemployment.* In recent years a third objective has been added to the list, the objective of economic growth; but for reasons that are too complex to be developed here, the objective of growth can in practice also be identified with the general goal of economic stabilization.**

In addition to the general objective of economic stabilization, expressed in the three goals of high employment, price stability, and economic growth, monetary policy has in practice another objective, resulting from the role of the central bank as fiscal agent for the government, the objective of assisting the government to borrow in the financial markets on the most advantageous terms obtainable. This objective, which becomes paramount in wartime, may conflict and in the past has in fact seriously conflicted with the use of monetary control for pur-

* This statement is phrased to avoid a final judgment on the issue of cost-push versus demand-pull inflation, and also to allow for the influence, important in Canada, of foreign price trends on the trend of domestic prices.

** This is not to say that a government pursuing the objective of growth would necessarily conduct monetary policy on traditional lines; rather, the point is that the scope for monetary policy alone to stimulate growth seems limited to whatever contribution economic stabilization can make to growth. This point is implicit in the rather unsatisfying discussion of objectives contained in the Report of the Commission on Money and Credit.

poses of economic stabilization. The problems raised by the conflict between the objectives of economic stabilization and cheap governmental financing, however, were most acute in the period before that with which the Commission is immediately concerned, and will accordingly be ignored for the most part in this paper.

More generally, this paper will ignore the possibilities of conflict between the objectives of monetary policy, important as they are to both the explanation of past policy and the formulation of future policy, and will instead be concerned with the use of monetary policy for the purpose of economic stabilization, defined in the very broad sense of damping cyclical fluctuations in the economy. The starting point of the argument is the assumption, presumed to be generally accepted, that the performance of monetary policy as an instrument for short-run economic stabilization in Canada in recent years has been definitely unsatisfactory.

It is not the purpose of this paper, however, to attempt to assign responsibility for the unsatisfactory record of Canadian economic policy with respect to economic stabilization in recent years. Instead, its purpose is to examine the merits and drawbacks of the alternative lines of action with respect to the guiding principles of future monetary policy that might be pursued by the Commission, in the light of the unsatisfactoriness of recent experience. For this purpose, it is sufficient to assume that the unsatisfactory record is the outcome of a combination of causal factors, which may include confusion in the minds of the government and the public with respect to the priorities of policy, insufficient coordination between the government and the Bank of Canada, errors on the part of the management of the Bank, and inadequate knowledge of the powers and limitations of monetary control of the economy on the part of all concerned.

Given the unsatisfactory nature of the record of the past, there are three main alternative positions that can be taken as to the conduct of monetary policy in the future. The first is to accept the record of the past as establishing that in practice monetary policy cannot achieve the degree of economic stabilization that has been expected of it, and to recommend that this fact be recognized by a corresponding writing-down of the standards for monetary performance to make them accord with what is achievable by monetary policy as operated in the past. The second is to take the record of the past as establishing that the performance of monetary policy with respect to economic stabilization could be improved by eliminating sources of error, and to recommend changes in the philosophy, institutional setting, and methods of monetary management that would help to improve performance. The third alternative

is to take the record of the past as establishing that monetary policy should not be entrusted with major responsibility for short-run economic stabilization, but should instead be directed to providing a stable long-run monetary environment, the responsibility for short-run stabilization being transferred to other instruments of economic policy. Broadly speaking, the second alternative corresponds to the approach of the American Commission on Money and Credit, and the third to the approach of the British Radcliffe Committee.

The main part of this paper is devoted to discussion of the arguments for and against these three approaches, and exploration of their implications for the reform of the Canadian monetary system. As a prerequisite to examination of these approaches, however, it is necessary to make explicit certain assumptions about the nature of central banking, the way in which monetary policy operates, and the philosophy of economic policy, since these assumptions are important to the argument. In addition, it is relevant to point out that the arguments concerning the various alternatives depend crucially on whether it is assumed that the country is on a fixed exchange rate or a floating rate, since the choice of a fixed-rate system imposes definite limitations on the freedom to use monetary policy for economic stabilization. Finally, whatever the approach adopted, it is necessary to consider the merits of various suggestions that have been made to give the monetary authority special powers of selective control over certain types of credit or certain kinds of credit institutions that are considered to play an especially destabilizing role in economic fluctuations. Accordingly, the paper begins with a statement of fundamental assumptions, goes on to comment on the relevance of the choice between fixed and floating exchange rates, discusses the three alternative approaches to future monetary policy, considers the case for and against various specific types of selective controls, and concludes with a summary section containing the author's personal judgments on some of the major issues.

Fundamental Assumptions

In order to discuss alternative approaches to the future conduct of monetary policy in a practically relevant way, it is necessary to take a position on three fundamental matters, all of which can be considered "practical" questions, though in different ways. These matters are the nature of a central bank as an institution, the way in which monetary policy affects the economy, and the philosophy of economic policy.

The importance of the institutional nature of a central bank derives from the fact that monetary policy is entrusted to its day-to-day man-

agement and influenced by its advice, rather than being managed directly by the government as an integral part of its general economic policy. The central bank is an independent corporation, not a government department; its personnel is selected by a different procedure than the Civil Service; and its routine activities bring it into intimate contact with one special sector of the economy, the financial system. It is only to be expected, therefore, that it will develop its own views on monetary policy, views that will be influenced in general by the habits of thinking about economic affairs prevalent in the financial community, especially by that community's concepts of "soundness" and of "financial morality," and in particular by the financial community's assessments of the nature of contemporary national economic problems and the policies appropriate to deal with them, whether these assessments are grounded in thorough economic analysis or not. Further, since the central bank is a national institution part of whose work brings it into contact with its opposite numbers in other countries, the central bank's thinking on domestic policy problems will be influenced by the thinking of other central banks about their own and its policy problems. Finally, since the central bank in its day-to-day operations must establish and maintain working relationships with the financial system of the country, and since its effectiveness depends on its ability to manipulate that system, it will naturally seek to conduct its operations so as to avoid disrupting the functioning of the financial system.

In these respects, the central bank is not of course uniquely differentiated from government departments; departments of labor and agriculture, in particular, typically share the attitudes of their clients and in part serve to represent the interests of those clients to the government. The difference, however, lies in the fact that the central bank is at least partially independent, and is entrusted to formulate and carry out national policies that may be in direct conflict with the interests of the financial institutions with which it is normally in close contact.

The institutional nature of the central bank imposes two important limitations on the possibilities for improvement of the conduct of monetary policy, so long as monetary policy is entrusted to the management of a quasi-independent central bank. In the first place, there are narrow limits on the extent to which a central bank can be converted into an institution that controls the monetary system according to principles and methods of analysis that are radically different from those understood and accepted by the financial community. Secondly, the central bank itself will inevitably generate strong resistances to the pursuit of a monetary policy that threatens to disrupt established financial rela-

tionships or expectations.* In short, if monetary policy continues to to be entrusted to the management of a central bank—an assumption that is axiomatic—this itself imposes limits both on how far and in what ways the management of monetary policy can be improved, and on how vigorous monetary policy can be made to be. Recognition of these limits, however, may lead to any one of the three alternatives previously mentioned: it may be argued that, given the institutional character of a central bank, one should not expect monetary policy to achieve a very high standard of economic stabilization; or that there is still a wide gap between the attainable and the attained, that could be significantly narrowed by feasible changes in central-bank management and operating procedures; or that the central bank could contribute more efficiently to the prosperity and growth of the economy if it were relieved of the responsibility for short-run economic stabilization.

To discuss alternative approaches to the conduct of monetary policy fruitfully, it is necessary to take a position not only on what can reasonably be expected of a central bank, but also on what monetary control can be expected to achieve. This necessitates a general view of how monetary policy affects the economy. The view that seems to emerge from the research and thinking underlying the *Reports* of the Radcliffe Committee and the Commission on Money and Credit can be summarized very broadly as follows. Monetary policy has a direct and observable influence on interest rates and credit conditions, and through changes in these variables has an observable effect on the flows of credit through certain markets, and notably on the volume of bank loans and on the demand for mortgage financing of new residential construction. But what matters for short-run economic stabilization is not control over interest rates and credit conditions, or even over the volume of particular types of lending, but control over the volume of expenditures. And except in the case of housing, where the situation is complicated by the large-scale intervention of the government as a guarantor of mortgages the terms of which make their attractiveness to institutional lenders vary countercyclically, it is virtually impossible to establish that monetary policy has a reliable, speedy, and quantitatively significant influence on final expenditure.

This difficulty has led some experts to conclude that monetary policy has no influence on the economy. On the other hand, the weight of

* Cf. Bank of Canada Submission II, §E, "Some Practical Considerations in Monetary Policy." This section amounts to the assertion that it is better to endure economic fluctuations than to counter them by a monetary policy that disturbs the financial system.

economic theorizing suggests that monetary policy ought to have some influence on economic activity; fragmentary evidence of such influence exists; and various well-known dramatic historical episodes testify that the influence of monetary factors can be significant, at least over the long run. Caution would therefore suggest the view that monetary policy does have an influence on economic activity, but that this influence varies with circumstances, with respect to both its magnitude and the time required for it to take effect. This view in turn suggests that the use of monetary policy for short-run stabilization is a difficult and hazardous enterprise.

This position, again, does not prejudge the issue between the three alternative approaches to the future conduct of policy. It can be argued with equal freedom that the central bank has done as well as could be expected, given the inherent difficulties of the task, and that there is no obvious way of improving its performance; or that the difficulties are a challenge to be overcome by more determined effort, requiring reform of the central bank to equip it better for an assault on the problems; or that the difficulties and risks of error are so great that the central bank would be better occupied with more modest responsibilities.

Finally, discussion of the alternatives requires a position to be taken on the general philosophy of control in a predominantly free-enterprise economy. Much of the discussion of monetary policy in the postwar period, and especially of "selective" techniques of control extending beyond the traditional "general" instruments of bank rate and open-market operations, has been concerned with questions of equity and consistency with the basic principles of a free-enterprise economy.* The position taken in this paper is the pragmatic one that the use of monetary policy, or for that matter any other "general" policy instrument, for the purpose of economic stabilization necessarily involves frustrating the plans of some sectors or individuals in the economy for the general good, and that in the economic world as it is this necessarily involves some inequity. Accordingly, the decision as to whether to supplement or substitute for traditional monetary policy by more selective methods of credit control should be taken on a balance of considerations of equity and effectiveness, rather than by reference to the pure principles of a competitive economy.

* These questions have even been raised with regard to the traditional instruments; in the United States it has been argued that control of the rediscounting privilege gives the central bank an undesirable degree of arbitrary authority; and both there and elsewhere the advocacy of "bills only" in open-market operations has been fundamentally a demand for fair competitive conditions for government-bond dealers.

The Relevance of the Exchange-Rate System

As previously mentioned, it makes a considerable difference to the argument concerning the three alternative approaches to the future conduct of monetary policy whether the country is assumed to be on a fixed or a floating exchange rate. A discussion of the issues involved in the choice between the two alternative exchange-rate systems is beyond the scope of this paper: this section is confined to the implications of that choice for what it is possible for monetary policy to attempt or attain. These implications are, however, relevant to the discussion of which exchange-rate system is preferable.

The point of most importance is the familiar one that a country on a fixed exchange rate is obliged to conduct its economic policy so as to keep its balance of payments balanced. More precisely, a fixed exchange rate obliges a country to keep fluctuations in its balance of payments within the limits set by its available international reserves, supplemented by its international borrowing power. Given the importance of short-term capital movements in the contemporary world, and their volatility in responding to interest-rate differentials or speculative sentiments, a country on a fixed exchange rate is likely to be obliged to conduct its monetary policy primarily by reference to the effects of domestic interest rates on international capital movements, and this may well necessitate the pursuit of a monetary policy contrary to that indicated by the objective of domestic economic stabilization.* In addition, the need to command international confidence, imposed by the presence of a large volume of internationally mobile short-term capital, may restrict the freedom of the monetary authority to use all the elbow-room potentially available to it, since confidence is inspired and maintained by conformity to what is regarded as orthodox financial behavior by other central banks and the owners of internationally mobile capital. Finally, the adoption of a fixed exchange rate may aggravate the task of economic stabilization because it provides maximum scope for the transmission of expan-

* In principle, the effect of international capital movements on the country's international reserve position could be overcome by operations in the forward-exchange market aimed at eliminating the covered interest differential between domestic and foreign capital markets. This technique was recommended to the Radcliffe Committee but rejected for what seem to be largely institutional reasons. The workability of the technique has been the subject of a continuing controversy among the experts; the United States monetary authorities claim some success in using it in the past two years. Whether it could be an adequately effective insulator for Canadian monetary policy is a question beyond the scope of this paper; suffice it to remark that exploitation of the technique in support of a monetary policy aimed at short-run stabilization would involve a higher degree of sophistication in monetary policy than has been customary in the past, and possibly a greater chance of error.